The Federal Report

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

The Month in Washington: November 2005

Congress rejoined the Iraq debate in November, after Pennsylvania Democratic Rep. John Murtha, a decorated Marine veteran, expressed frustration and pessimism regarding the progress of the war and proposed a resolution urging that U.S. armed forces in that nation be pulled out "at the earliest practicable date." House Republicans on Nov. 18 held a vote on a resolution calling for the "immediate" withdrawal of troops, which produced a debate that ended with the measure being defeated 403-3. (Murtha voted against the proposal.) Meanwhile, the special prosecutor in the Valerie Plame CIA leak case announced that he will continue his investigation with a second grand jury after the 18-month term of the first one expired in October following the indictment of Irving Lewis "Scooter" Libby, the then-chief of staff to Vice President Cheney.

Issues and Events

Senate Passes Pension Reform Bill

A pension reform bill that had appeared to be stalled in the Senate passed the chamber by a 97-2 vote on Nov. 16 but still faces an uncertain future.

The Pension Security and Transparency Act of 2005 would revise funding rules for private sector pension plans, generally giving companies seven years to eliminate shortfalls, and increase the premiums paid to the Pension Benefit and Guaranty Corporation (PBGC), the federal agency that insures private pensions. In addition, the legislation includes several provisions that would affect public pensions, including measures to clarify purchase of service credit rules; waive the 10 percent early withdrawal penalty for public safety workers who are at least 50 years old; and clarify minimum distribution rules for governmental plans.

A vote on the bill had been blocked by Sens. Barbara Mikulski, D-Md., and John Ensign, R-Nev., both of whom objected to a provision that would link a company's credit rating to its pension funding status. Mikulski and Ensign agreed to let the bill go forward, though, with the understanding that the issue would be worked out during conference negotiations with the House, which is expected to vote on its pension reform bill – the Pension Protection Act of 2005 – in early December. The House bill, which was approved by the chamber's Ways and Means Committee on Nov. 9, in addition to revising pension funding rules and increasing PBGC premiums, would:

- allow public safety employees who retire or become disabled to take tax-free distributions of as much as $5,000 a year from governmental pension plans to buy health or long-term care insurance;

- waive the 10 percent penalty for early withdrawals for distributions made to public safety employees in connection with a DROP benefit;
- make permanent the IRA and pension provisions of the 2001 tax cut bill;
- make the "saver's credit" for contributions to IRAs and qualified pension plans permanent; and
- allow for automatic enrollment in defined contribution plans.

Besides the credit rating issue, House and Senate negotiators would also need to address a measure in the Senate bill that gives airlines 20 years before the new funding rules begin. This provision is one of several that has prompted the Bush administration to express doubts about whether the legislation would actually tighten funding requirements and to threaten a veto. A PBGC study concluded in October that the phase-in of new funding rules would actually result in reduced contributions to pension plans and more plan defaults.

Social Security Reform Officially Dead for 2005

The absence of a Republican Social Security reform measure from the pension bill reported by the House Ways and Means Committee on November 9 (*see story above*) signaled the official death of this year's efforts to add personal investment accounts to the program.

Republicans, led by Ways and Means Chairman Bill Thomas, R-Calif., had said through the summer that they planned to produce a retirement reform package that would include not just the Pension Protection Act of 2005 but also language to reform Social Security, most likely the Growing Real Ownership for Workers Act of 2005, which would create individual accounts using the Social Security surplus. The GOP's Social Security reform plans, though, were thrown off track by other business, such as responding to Hurricane Katrina and getting long-overdue spending bills passed. The efforts were not helped by nearly unanimous opposition to their plans by Democratic lawmakers and reluctance among many Republican moderates to move Social Security away from its guaranteed benefits.

In the Senate, meanwhile, Finance Committee Chairman Charles Grassley, R-Iowa, said that he is "very pessimistic" that Social Security can be reformed anytime soon, and he predicted that Congress would not take up the issue before a new president takes office in 2009.

Panel Recommends Major Tax Changes

The U.S. tax code would look very different if the recommendations issued Nov. 1 by the President's Advisory Panel on Federal Tax Reform are enacted.

The panel, which was appointed by President Bush in January, has suggested that two of the most strongly supported parts of the tax code – the mortgage interest deduction and the exemption of employer-paid health insurance premiums from gross income – be revised. The panel recommended replacing the mortgage interest deduction with a tax credit equal to 15 percent of the interest paid, with limits based on the average cost of housing in a given taxpayer's region. The commission also recommended that caps be placed on the amount of health insurance premiums that can be paid by employers on a non-taxed basis – $5,000 a year for individuals and $11,500 for families.

While the panel did not recommend any changes that would directly affect defined benefit pension plans, it did suggest major revisions to defined contribution plans. "Save at Work" plans would replace 401(k)s, 403(b)s and similar job-based plans, using the rules now in place for 401(k)s. "Save for Retirement" plans would replace IRAs, Roth IRAs and similar plans and would allow for annual contributions of as much as $10,000, tax-free growth and tax-free withdrawals after age 58. "Save for Family" plans would be similar to "Save for Retirement" plans, but would allow tax-free and penalty-free withdrawals before age 58 for health, education and home purchase expenses.

Other suggestions included:

- Eliminating the exclusion from business income of municipal bonds.
- Effectively reducing the capital gains tax rate to 8.25 percent when stocks are held for more than a year.
- Eliminating the itemized deduction for state and local taxes.
- Eliminating most tax preferences for fringe benefits, such as employer-paid childcare and life insurance premiums.
- Revising the taxation of Social Security benefits, imposing the tax on individuals with incomes of at least $22,000 and couples with incomes of at least $44,000.

Sign-Up Period for Medicare Drug Benefit Begins

Seniors began signing up for the new Medicare Part D prescription drug benefit on Nov. 15.

The benefit, which is to begin Jan. 1, will cost the average senior about $32 a month in premiums. It will have an annual deductible of $250 and cover 75 percent of drug costs up to $2,250. Coverage then stops until spending reaches $5,100, at which point, 95 percent of additional costs are covered. The benefit is projected to cost taxpayers $720 billion over the first 10 years.

The day before the enrollment period began, eight advocacy groups, including the Congress of California Seniors, filed a federal lawsuit against Health and Human Services Secretary Mike Leavitt seeking to ensure that none of the nation's 6.4 million "dual eligibles" – seniors who are eligible for both Medicare and Medicaid – lose coverage when they are transitioned from Medicaid's drug coverage to the new Medicare plan.

Eligible seniors can sign up until May 15 without penalty, although some Democratic lawmakers are seeking to push back that date.

Bill Would Increase Executive Compensation Disclosure

Companies would have to disclose more information to shareholders about their executive compensation plans if a bill proposed by Rep. Barney Frank, D-Mass., becomes law.

The Protection Against Executive Compensation Abuse Act would require companies to include in annual reports and proxy solicitations details of all forms of compensation given to executives; the policies on which executive compensation packages are based; and the policies for recapturing performance-based compensation that was later revealed to have been inappropriately awarded. The compensation plan would be subject to a vote by shareholders.

The bill is now in the House Financial Services Committee, on which Frank is the senior Democrat.

Strategic Recommendations

LGV&A is not offering any new strategic recommendations to the Board this month.

California Congressional Delegation

Cash Balance Conversions Can Cut Benefits for All: GAO Study

Conversions from defined benefit pension plans to cash balance plans tend to reduce retirement benefits for workers of all ages unless protections are put in place, according to a study released Nov. 4 by the Government Accountability Office (GAO), Congress' investigative agency.

Cash balance plans combine features of defined benefit (DB) and defined contribution plans, assigning accounts to individual workers into which contributions are made and a specific rate of growth is guaranteed. Some companies have converted from traditional DB plans to cash balance plans in the interest of funding stability, but critics charge that such conversions discriminate against older workers by sharply reducing their retirement benefits. The GAO study found that half of 50-year-olds whose plans undergo such conversions lose an average of $238 in retirement benefits each month. It also found, though, that nearly all 30 and 40-year-olds also lose money, an average of $59 and $188 a month, respectively. (Many companies that have converted have put protections in place to prevent such benefit cuts.)

The House is expected to vote on a GOP-backed pension reform bill that addresses conversion rules, but Democrats say the legislation does nothing to protect workers in such circumstances.

"House Republicans are pushing pension legislation that is rife with problems, like saying to employers that it's acceptable for them to cut the retirement benefits of older workers," Rep. George Miller, D-Calif., one of the lawmakers who requested the GAO study, said. "Workers have made career and financial decisions based upon these benefit promises, and they should not have their retirement plans dashed at the whims of the companies they've loyally served."

Related National and Industry News

The portion of Americans under age 65 with health coverage reached 82.2 percent, a 10-year high, in 2004, even as the percentage with employer-based coverage declined slightly, according to a study from the Employee Benefit Research Institute.

About two-thirds of Americans – 66.8 percent – had employer-based coverage in the year 2000, up from 64.4 percent in 1994, but that number dropped to 62.4 percent in 2004. The percentage covered by public programs went in the opposite direction, dipping between 1994 and 1999 and rising from 2000 to 2004.

"If current economic conditions persist or worsen, maybe due to the economic fallout of hurricanes Katrina and Rita, coupled with the rising cost of providing health benefits, the nation is likely to continue to see an erosion in the percentage of individuals with employment-based health insurance coverage, and – if public programs do not keep pace with this erosion – more individuals without health insurance," the study warned.